A. A Market-Based Approach Should Lead To A More Efficient Interstate Access Market Than A Prescriptive Approach.[35]

A properly designed and enforced market-based approach to lowering interstate access rates has several advantages over a prescriptive approach. First, as the Commission has long recognized, prices set by prescriptive regulation are not as efficient as those determined by a competitive market. Moreover, while a prescriptive approach might increase short-term static efficiencies (bringing prices closer to the ILECs' costs), a market-based approach will establish the preconditions for the development of more beneficial dynamic efficiencies (the entry of firms with costs that are lower than the ILECs'). For this reason, the development of competition over the long term would be more beneficial than the short term benefits of prescription. To the extent that local exchange and exchange access competition is more likely to develop under a market-based approach, that approach should be adopted.

Without ILEC cooperation, which is more likely under a quid pro quo arrangement, local entry is much less likely to occur on a significant scale. Of course, the FCC and state commissions have gone far in implementing the mandate of the Telecommunications Act of 1996 to establish the preconditions for competition in the local telecommunications market. But despite the regulators' best

35 This Subsection relates to Section V of the Notice.

efforts, it will be very difficult to force ILECs to act against self-interest and cooperate in lowering barriers to their core business.

The FCC faced a similar problem when it attempted to compel the Bell System to cooperate in permitting entry into the long distance business.[36] Indeed, it was the failure of regulatory mandates to achieve such cooperation that formed the basis of the government's case in United States v. AT&T.[37] As Judge Greene observed:

> [D]espite the decades-old requirements in the Communications Act, 47 U.S.C. § 202(a), and various FCC regulations requiring non-discrimination, equal access, and proper cost allocations, and notwithstanding the Commission's own persistent and dedicated efforts for a remedy, the FCC was unable to prevent or to remedy major anticompetitive abuses by the Bell System achieved through the activities of its local affiliates.[38]

Even Section 271, which is designed in part to give BOCs the incentive to cooperate in the establishment of the preconditions for competitive entry, is a helpful but insufficient mechanism for encouraging cooperation. First,

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36 See e.g., United States v. AT&T, 524 F. Supp. 1336, 1352-1357 (D.C. Cir. 1981) (describing evidence offered by the Department of Justice regarding AT&T's largely successful attempts to prevent the introduction of competition in the long distance competition, often in spite of regulatory mandates).

37 See United States v. Western Elec. Co., 673 F. Supp. 525, 568 (D.D.C. 1987) (quoting the Justice Department's assertion that "[a]t the heart of the government's case in United States v. AT&T was the failure of regulation to safeguard competition in the face of powerful incentives and abilities of a firm engaged in the provision of both regulated monopoly and competitive services").

38 Id. at 567.

Section 271 does not apply to ILECs such as those owned by GTE and Cincinnati Bell that are not affiliates of RBOCs. Further, the Section 271 review process is conducted on a state-by-state basis and therefore does not lend itself as easily to a targeted analysis of competition in each particular market within a state.[39] Moreover, a quid pro quo market approach to local competition provides RBOC ILEC affiliates a greater incentive to cooperate in permitting entry.[40]

There is also a more general reason why it makes sense to insist on a high standard for permitting further pricing flexibility, one likely higher than the standard for interLATA entry. Admittedly, competition in the long distance market could be harmed if Section 271 relief is granted before substantial local competition develops. But local competition might never develop at all if extra pricing flexibility is granted before substantial competition develops. It is therefore especially urgent that the proper market-based approach, with the proper incentive mechanisms, is adopted for access reform.

[39] See Section III.F below for a discussion of service and geographic market definition.

[40] Of course, TWComm understands that the ILECs may in some cases view the costs of lost market share to outweigh the benefits of increased pricing flexibility. Still, the market-based approach allows the FCC to manage a phased transition to competition. As a practical matter, Section 271 contemplates only a single phase.

B. The Phase I Competitive Checklist Should Be A Modified Version Of The Section 271 Checklist.[41]

The competitive checklist for Phase I should contain the items that are necessary for competitive entry into the local telephone market.[42] The checklist contained in Section 271(c)(2)(B) would suffice as long as three modifications are made to that list. First, the rates at which unbundled elements and transport and termination are available must comply with the methodologies established in the Interconnection First Report and Order. This is the approach that the Commission seems to be proposing in the NPRM.[43] It is a sound one.[44]

Second, the obligation to provide interconnection in accordance with Sections 251(c)(2) and 252(d)(1)[45] must be understood to include physical and virtual collocation. Indeed, further pricing flexibility should not be available

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41 This Subsection relates to Section V.B of the Notice.

42 Competition in the local exchange market is inextricably linked to competition in the access market.

43 See Notice at ¶¶ 170-179.

44 The Notice also proposes to require that ILEC services should be available at a wholesale discount based on "avoidable" rather than "avoided" costs. See Notice at ¶ 174. TWComm does not support this interpretation, as it has explained in a Petition for Reconsideration of the Interconnection First Report and Order. See Petition for Reconsideration of Time Warner Communications Holdings, Inc. filed in CC Docket No. 96-98. Accordingly, TWComm recommends that ILECs be required to offer retail rates at a wholesale discount based on avoided costs as a precondition to Phase I pricing flexibility.

45 See 47 U.S.C. § 271(c)(2)(B)(i).

for any ILEC whose collocation tariffs are subject to an FCC investigation, as is currently the case with virtual collocation tariffs.

Third, ILECs should be required to certify that they intend to meet the FCC's implementation schedule for full number portability and will not file a waiver of the deadlines established in that schedule. Similarly, where a BOC files an application for increased pricing flexibility within the three month period for required deployment of full number portability in a particular market, the Commission should not grant the request until full number portability has in fact been deployed.

C. Section 271 Approval Should Not Automatically Result In Phase I Pricing Flexibility.[46]

Adopting the Section 271 checklist for the purposes of Phase I does not necessarily mean that a BOC that has received Section 271 approval for a state should receive Phase I pricing flexibility for all geographic areas within that state. Of course, if the Commission applies the Section 271 checklist in the manner described in the previous section, it would be appropriate to consider the checklist requirements as having been met for the purposes of Phase I for all geographic areas within the state.

As explained below, however, an ILEC should not be eligible for Phase I pricing flexibility for a service until substantial competition develops for that service in the

46 This Subsection relates to Section V.B of the Notice.

relevant market. Even were Section 271 approval to be granted in a state before such competition has developed for a particular interstate access service (and we submit that the Commission should not allow that to occur), Phase I flexibility should not be granted for that service until such competition develops.

D. ILECs Should Be Required To Demonstrate The Existence Of Substantial Competition Before Receiving Phase I Pricing Flexibility.[47]

The pricing flexibility described in Phase I of the Commission's market-based approach should not be granted for a service until that service is subject to substantial competition in the defined geographic market. Granting extra flexibility before the ILEC can demonstrate such competition develops would be destructive, unnecessary and a violation of Commission precedent.

1. Granting Premature Phase I Pricing Flexibility Will Reduce The ILECs' Incentive To Cooperate In Lowering Entry Barriers.[48]

Granting Phase I pricing flexibility before substantial competition has been demonstrated for a particular service would reduce the ILECs' incentive to cooperate with lowering entry barriers. Such cooperation is necessary for the successful provision of the checklist services to competitors. If ILECs are permitted to "eat the carrot" before firms that must rely on these services are able to

[47] This Subsection relates to Section V.B of the Notice.

[48] This Subsection relates to Section V.B of the Notice.

enter the market, ILECs are more likely to effectively withhold cooperation in the provision of those services.

The Commission has relied on just this reasoning in the past to require cooperation with entry as a prerequisite to pricing flexibility. For example, in its Virtual Collocation Order, the Commission stated:

> If pricing flexibility were not related to the implementation and subsequent development of expanded interconnection, LECs might not have the incentive to act cooperatively in the implementation of expanded interconnection.[49]

There is every reason to apply this reasoning in the current context.

2. Regulators Cannot Be Certain That Entry Barriers Have Been Lowered Until Competition Has Developed.[50]

As TWComm and other CAPs have experienced in the collocation context, interconnection and the provision of other essential services is an extremely complex process which provides ILECs with virtually endless opportunities for anticompetitive behavior. The FCC cannot be certain that the barriers to entry have actually been lowered in a market until the ILEC is actually delivering checklist services to competitors that offer the particular access service in the market.

[49] Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Memorandum Opinion and Order, 9 FCC Rcd 5154, 5424 (1994) ("Virtual Collocation Order").

[50] This Subsection relates to Section V.B of the Notice.

As a threshold matter, the Commission should not lose sight of the considerable pricing flexibility embodied in the existing price cap rules. Lower price bands have now been eliminated, and ILECs have a limited ability to offset price decreases for services with price increases for other services in the same basket. The Commission has also allowed substantial volume and term discounts as well as geographic deaveraging for transport services upon a demonstration of competition.

Thus, substantial competition for a service must be required before extra Phase I pricing flexibility is permitted for that service. This targeted service-by-service approach will ensure that ILECs cannot try selectively to permit entry in some services in a geographic market while resisting entry in others.

Moreover, the Commission must require that the competition come from firms that are predominantly facilities-based (as opposed to those relying predominantly on leased network elements or resold services or some combination of the two). Only competition from firms with their own independent facilities can ultimately discipline ILEC pricing. Moreover, investment in independent facilities is by far the best indication of firms' confidence that a particular market has been sufficiently opened to permit competition. As explained below, waiting until such investment is made before granting further pricing flexibility will not harm ILECs or encourage inefficient entry if the ILEC rates have been properly restructured.

3. There Is No Need To Permit Phase I Pricing Flexibility Until Substantial Competition Has Developed.[51]

The Commission appears to believe that permitting extra pricing flexibility upon compliance with the Phase I competitive checklist will deter inefficient entry and will result in lower access prices.[52] However, granting added pricing flexibility will fail to serve either of these goals without a prior demonstration that competition has developed.

First, Phase I flexibility does not need to be granted before competition develops to deter inefficient entry. A clear FCC policy of granting more pricing flexibility upon the demonstration of viable competition in a particular market will provide adequate deterrence against most firms entering solely to take advantage of opportunities created by regulation.

Nor is pricing flexibility generally required to prevent inefficient entry by firms providing service over unbundled network elements priced at forward-looking cost. Assuming rate restructuring and rebalancing has been accomplished in the manner recommended above and that the other relevant regulations (universal service and

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51 This Subsection relates to Section V.B of the Notice.

52 See Notice at ¶ 168.

separations) have been reformed, ILECs will be able to charge access prices that more closely reflect the manner in which they incur costs and rate elements should not generally be priced to subsidize another element (or another purchaser's access).

The difference between access purchased through unbundled elements and purchased through interstate price cap offerings should be that the former is priced to recover historical costs while the latter may be priced lower, depending on the applicable regulations. Unless network elements are priced below forward-looking cost (a problem that must be fixed independent of access reform), the proper rate restructuring along with the pricing flexibility granted by the FCC in the Price Cap Third Report and Order will allow the ILEC to meet competition from unbundled elements with its own lower prices.[53]

There would appear to be only one possible exception to this general approach. Where an ILEC must offer unbundled elements on a geographically deaveraged basis, new entrants may have an artificial incentive to try to win end users so that they can purchase elements instead of price cap access services. If the Commission determines that this is in fact taking place, it would be appropriate to permit the ILEC to

[53] For example, there should be nothing about the pricing of unbundled elements that would require that ILECs be able to grant either volume/term discounts or contract-based tariffs in order to compete.

deaverage its access prices to eliminate the resulting inefficiencies.[54]

Finally, the Commission's concern that Phase I pricing flexibility is necessary if access customers are to realize the benefit of lower prices is misplaced. The elimination of lower pricing bands will almost certainly be adequate (probably excessive) flexibility for consumers of access services to benefit from lower prices before substantial facilities-based competition has developed.

4. Permitting Phase I Pricing Flexibility Before Competition Has Developed Violates FCC Precedent.[55]

The Commission has a long-standing policy of providing pricing flexibility to dominant carriers only after it finds that an adequate level of competition exists in the relevant market. A reversal of this policy without an explicit and reasonable rationale would be arbitrary and capricious and therefore subject to reversal on appeal.

In the Notice, the Commission proposes granting ILECs substantial extra pricing flexibility for interstate access services regardless of the level of competition in the

[54] Deaveraging that is not cost-based should of course be prohibited. For example, there appears to be no reason why switching prices should vary from one region to another. Unless ILECs are able to show that it is justified, the FCC should therefore prohibit geographic "deaveraging" for switching. In addition, geographically deaveraged rates should require detailed cost justification with opportunity for third party review and comment.

[55] This Subsection relates to Section V.B of the Notice.

relevant market.[56] As proposed in the Notice, in exchange for compliance with the checklist, the ILECs would be granted the right to (1) offer volume and term discounts, (2) offer contract tariffs and RFP responses, (3) geographically deaverage prices, and (4) be free of pricing constraints on new access services.[57]

This approach represents an almost complete departure from FCC precedent. For example, the Commission required a showing of a threshold level of competition (the equivalent of substantial competition) in the relevant market before permitting ILECs to offer volume and term discounts on switched transport services.[58] In so doing, the Commission noted that the ability of ILECs to provide volume and term discounts for switched transport "should be linked to a demonstration that the LEC's switched expanded interconnection offering presents a viable competitive opportunity."[59]

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56 For example, the Commission proposes "to eliminate four significant regulatory constraints when an incumbent LEC can demonstrate that it faces potential competition for interstate access services." Notice at ¶ 168.

57 Id.

58 See Virtual Collocation Order at 5204, ¶ 182. Specifically, ILECs are permitted to offer switched transport with volume and term discounts only after either 100 DS-1 equivalent switched cross-connects are operational in the Zone 1 offices of the study area or an average of 25 DS-1 equivalent switched cross-connects per Zone 1 office are operational. Id. at ¶ 177.

59 Id. at ¶ 182 (emphasis added). Further, the Commission emphasized that "[p]ermitting volume and term discounts for switched transport is a substantial departure from our past practice, and must be done cautiously." Id. at ¶ 183.

Further, the FCC only permitted AT&T to offer contract tariffs after it determined that "the business services marketplace [for which contract tariffs were being considered] is substantially competitive."[60] Based on this determination, the Commission permitted AT&T to file contract tariffs for the services subject to this level of competition.

The potential harm to competition is especially great where contract tariff rights are granted prematurely. Yet the Commission offers virtually no explanation for its startling proposal to now permit contract tariffing for services subject to no competition at all. Indeed, it openly acknowledges that the proposal threatens competition:

> At Phase I, the entry barriers to competition will have been removed, but competition may not yet be sufficient to restrain the incumbent LEC from raising prices unreasonably for those customers not under contract tariff.[61]

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[60] Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, Report and Order, 6 FCC Rcd 5880, 5887 at ¶ 36 (1991) (emphasis added) ("AT&T Contract Tariff Order"). First, the Commission determined demand-elasticity for business services was high. See id. at ¶¶ 37, 40. Second, after reviewing studies and analyses of traffic volumes and supply capacity, the Commission concluded that supply elasticities in the interstate interexchange market were high. See id. at ¶ 46 Third, the Commission found that AT&T had never exceeded the price cap ceiling for the relevant basket and had a market share in business services of about fifty percent. See id. at ¶¶ 49-50. The Commission noted that, combined with the high demand and supply elasticities of the market, a fifty percent market share was indicative of a highly competitive market. See id. at ¶ 51. Finally, the Commission concluded that "competition in business services is thriving . . . AT&T's competitors are growing, and . . . consumers are benefitting [sic] from these occurrences." See id. at ¶ 61.

[61] Notice at ¶ 195 (emphasis added).

Of course, this is correct. ILECs will have the incentive and the opportunity to engage in unlawful cross-subsidy and discrimination if contract tariff rights are granted before the relevant services are subject to substantial competition. Specifically, ILECs could lower rates to fend off competition for strategically targeted customers by using contracts whose terms effectively limit the offering to a single purchaser. This would both stifle competitive entry and prevent other purchasers from receiving the benefits of lower access prices.[62]

The Commission's only basis for granting contract tariff rights before substantial competition is its observation that "certain interconnection arrangements may be substitutable for access services" and that such arrangements "may well place greater pressure on prices for [ILEC] access services at an earlier phase in the development of competition than existed for AT&T."[63] If this is a reference to the pressure placed on rates by network element prices, the proper remedy is cost-based rate

[62] PacTel's proposal to remove contract tariff carriage service when calculating ILECs' actual price cap indices cannot prevent this anticompetitive behavior. Such a reform would only make cross-subsidy of contract rates somewhat easier to detect. It would not eliminate the incentive and opportunity for ILECs to strategically underprice service to customers targeted by new entrants. See Section E below for a discussion of the ILECs' incentive to engage in predatory pricing.

[63] Notice at ¶ 195.

restructuring and rebalancing, not the freedom to selectively drop rates for targeted customers.

In the case of geographic deaveraging, the Commission has again required a demonstration of competitive entry before permitting geographic deaveraging of access rates. In the Virtual Collocation Order, the Commission permitted ILECs to deaverage switched and special access rates on a geographic basis through zone density pricing only after "operational" expanded interconnection offerings for the respective services were offered in a study area.[64] The Commission defined expanded interconnection offerings as "operational" only "when and if an interconnector has taken a cross-connect element in connection with a tariffed expanded interconnection offering."[65] While this standard is not the equivalent of substantial competition, it at least shows the requirement of some competitive entry.[66]

Moreover, the same logic should apply to removing the pricing constraints on new access services. Without the discipline of substantial competition, an ILEC could use this flexibility to inhibit or prevent the development of widespread entry. The relaxed regulatory treatment would allow an ILEC to label unbundled pieces of pre-existing

64 Virtual Collocation Order, 9 FCC Rcd at 5196, ¶ 153.

65 Id. at ¶ 154.

66 As mentioned above, it may indeed be appropriate to permit limited geographic deaveraging in certain markets where substantial competition has not yet developed.

services as "new." The ILEC could then quickly establish uneconomic rates for the unbundled pieces of various "old" services upon which new entrants must rely to provide service. This would drive up the new entrants' costs and harm competition. Thus, in the case of new service regulation, there is every reason to apply the traditional Commission policy of requiring competition before allowing more pricing flexibility.

Indeed, the Commission lacks the authority to abandon its policy of requiring competition before pricing flexibility without providing a reasonable basis for doing so. As the Supreme Court has held, when reversing its policy, "an agency must cogently explain why it has exercised its discretion in a given manner,"[67] and "must offer a 'rational connection between the facts found and the choice made.'"[68] Indeed, Circuit Courts have consistently upheld challenges to Commission decisions for precisely the same reason: a failure by the Commission to offer a reasoned explanation for a change in policy.[69] Here, the

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67 Motor Veh. Mfrs. Ass'n. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 48 (1983)(citations omitted).

68 Id. at 52 (quoting Burlington Truck Lines, Inc. v. U.S., 371 U.S. 156, 168 (1962)).

69 See, e.g., Achernar Broadcasting Co. v. F.C.C., 62 F.3d 1441 (D.C. Cir. 1995)(remanding licensing decision to the Commission for failure to provide a reasonable explanation for the change in policy underlying its decision); see also MCI Telecommunications Corp. v. F.C.C., 59 F.3d 1407 (D.C. Cir. 1995), cert. dismissed sub nom. BellSouth Telecommunications, Inc. v. F.C.C., 116 S.Ct. 1458 (1996), *and* cert. denied, 116 S.Ct. 1890 (1996) (vacating and remanding part of a Commission order, despite attempted

Commission must articulate some rational basis for changing a major principle of telecommunications regulation such as this (and there is no such basis).[70]

E. The Commission Must Closely Monitor ILEC Behavior.[71]

As ILECs receive more pricing flexibility, there is a very real danger that they will be able to leverage their dominant position in the market to prevent further entry and limit the ability of existing entrants to expand. In the

justification by the Commission for its decision, because the inconsistency of the Commission's decision with Commission precedent was not explained convincingly). Further, the D.C. Circuit has noted that "[a]n agency in its deliberations is under an obligation to follow, distinguish, or overrule its own precedent." Local 777, Democratic U. Organizing Com. v. N.L.R.B., 603 F.2d 862, 872 (D.C. Cir. 1978)(citations omitted).

70 The record is replete with examples other than the ones listed above of the Commission's policy of requiring a showing of some competition before granting pricing flexibility. Thus, the Commission did not grant NYNEX its requested waiver of certain access charge rules until the FCC had completed an analysis of the competitive conditions of the relevant markets and, after doing so, granted the requested relief only in the market where competition had actually begun to develop. See The NYNEX Telephone Companies Petition for Waiver, FCC 95-185, Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995). Moreover, in granting Ameritech a waiver of certain access charge rules, the Commission first determined that sufficient competition had emerged in the relevant LATAs to justify allowing the requested pricing flexibility. See Ameritech Operating Companies Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, FCC 96-58, Order, 2 CR 750 (1996). Although the Commission did not explicitly apply a substantial competition standard in these cases, the flexibility granted was more akin to the rate restructuring reform proposed in the Notice than to Phase I flexibility. A lower standard was therefore appropriate.

71 This Subsection relates to Section V of the Notice.

Notice, the Commission gave only minimal acknowledgment of the incentives for anticompetitive behavior that pricing flexibility creates. But the FCC's price cap scheme and the ILECs' dominant market share give them the opportunity and incentive to employ many exclusionary tactics. The Commission must therefore closely monitor ILECs before and after the checklist requirements have been met to ensure that local competition is not impeded.

1. The FCC's Price Cap Scheme Creates Significant Anticompetitive Incentives For ILECs To Resist Competition.[72]

The Commission's price cap scheme creates many of the inefficient incentives that exist under rate-of-return regulation.[73] Of particular importance to the development of competition in the local telephone market is the incentive to cross-subsidize services within a price cap basket. Specifically, since some of the price cap baskets in the current regime contain more than one service, ILECs may have the incentive to cross-subsidize competitive services with revenues from less competitive services within the same basket.

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[72] This Subsection relates to Section V.B and C of the Notice.

[73] Rate of return regulation (1) limits the regulated firm's incentive to reduce costs, (2) distorts the firm's input choices, and (3) if the regulated firm produces more than one service and regulation effectively limits overall profits, rate of return regulation gives a firm the incentive to shift costs from more competitive to less competitive services.

As mentioned in the Notice, the Commission has tried to prevent this strategy by placing services subject to similar levels of competition in the same basket and by placing upper and lower pricing bands on the services within those baskets. But the process of grouping together service subject to similar levels of competition is unavoidably imperfect. The result is that ILECs currently have the ability, limited only by upper pricing bands, to cross-subsidize services within baskets.

The Commission's decision in the Third Report and Order to eliminate lower pricing bands has only increased the opportunity to cross-subsidize within a basket.[74] An ILEC subject to competition will have the ability to lower prices as much as necessary on the competitive service and raise the prices of other services to the extent permitted by upper pricing bands. Competition would inevitably require the ILEC to lower its prices for competitive services. But the ILEC's dominant market power allows it to reduce the losses caused by competition by raising prices on less competitive services.

[74] The flexibility proposed for Phase I would, of course, only increase this opportunity even further.

2. Dominant Firms Have The Incentive To Engage In Anticompetitive Behavior To Resist Competition.[75]

Dominant firms have the incentive to engage in both predatory and strategic pricing to prevent competition from developing. In the previous Price Cap NPRM which gave rise to the Third Report and Order, the Commission recognized the opportunity for predation that downward pricing flexibility creates. The Commission consequently proposed a protection against predation: a 1% per year limit on price increases following price reductions made pursuant to pricing flexibility.[76] The Commission's failure to adopt this protection as part of the Third Report and Order means that it is already much more likely that ILECs could engage is classic predation by lowering prices below cost, forcing rival firms from the market and subsequently raising prices to recoup any losses sustained.

In addition, ILECs have the incentive to use non-price tactics to raise the costs of their competitors or potential competitors. This could be accomplished by (1) degrading the quality of access or network services the ILEC offers to downstream competitors, (2) providing downstream affiliates with improved software before providing it to competitors,

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75 This Subsection relates to Section V.B and C of the Notice.

76 See Price Cap Performance Review for Local Exchange Carriers, CC Docket Nos. 94-1, 93-124, 93-197, Second Further Notice of Proposed Rulemaking, FCC 95-393, at ¶ 105 (1995).

or (3) delaying offering new technical input configurations to its downstream competitors until its own affiliates are prepared to make the change.

3. The Commission Must Monitor Post-Phase I ILEC Behavior.[77]

In light of these incentives, the Commission must remain vigilant for signs that ILECs are engaging in exclusionary behavior. For example, the Commission should monitor the extent to which price increases and decreases are linked in time and assess the extent to which the price increase occurred for a less competitive service. If the price increase is not caused by increases in incremental cost, there is a good chance the ILEC is engaged in cross-subsidy.

The Commission must also watch for signs that an ILEC is successfully engaging in exclusionary behavior. Thus, the Commission should watch the extent to which firms enter and exit the market (especially after an ILEC has been granted Phase I pricing flexibility). Similarly, the extent to which firms are able to expand their entry should be monitored.

Finally, the Commission should remain vigilant for instances of ILECs providing downstream competitors with lower quality inputs of production than they provide to

[77] This Subsection relates to Section V.B and C of the Notice.

their affiliates. Such behavior could occur in any interconnection context.

F. Effective Implementation Of The Market-Based Approach Requires That Markets Are Properly Defined.[78]

In defining the service and geographic markets for the purposes of the market-based approach, the Commission should be careful to account for potential cross-subsidy opportunities.[79] TWComm recommends that the Commission consider the following three factors when defining markets.[80]

First, although the Commission does not regulate intrastate service, the relevant economic markets encompass both intrastate and interstate access services. Thus, entrants should be providing an access service on both an intrastate and interstate basis before Phase I flexibility is granted. Similarly, both the intrastate and interstate markets for a particular service must be characterized by substantial competition before Phase II flexibility may be granted.

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78 This Subsection relates to Section V of the Notice.

79 The issues discussed in this section are covered in greater detail in the pages from TWComm's comments in CC Docket Nos. 94-1, 93-124, 93-197 which are attached as an Appendix.

80 TWComm recommends below that the Commission not attempt at this time to establish detailed standards for Phase II. The discussion of market definition is included here because it may be necessary to define the same markets for both Phases I and II.

Second, the relative presence or absence of shared costs among products or among geographic areas should be considered in the context of Phase II. The presence of a high percentage of shared costs creates a strong incentive for the ILEC to shift costs from a competitive service or geographic area to a less competitive service or geographic area. The higher the percentage of shared costs in such a situation, the greater the incentive to cross-subsidize.

Third, the relevant geographic markets should be sufficiently large to prevent the shifting of common costs between markets subject to different levels of competition. For example, a wire center would not be large enough. Such a market definition would create opportunities for shifting common costs from wire centers characterized by the competitive entry to wire centers with minimal competition. LATAs would probably provide adequately sized and configured markets.

G. There Is No Need To Define The Requirements Of Phase II At This Time.[81]

The administrative burden of reforming access charge rate structures, defining the parameters of Phase I of the market-based approach as well as reforming universal service and reviewing Section 271 applications are enormous. These issues should be the focus of the FCC's attention. There is no need to add unnecessarily the task of detailed rules for Phase II of the market-based approach, since Phase I has not

[81] This Subsection relates to Section V.C of the Notice.

even been designed or met by any ILEC. The Commission should therefore defer its review of this issue until a later proceeding.[82]

IV. ILECS SHOULD BE GIVEN THE OPPORTUNITY, BUT NOT THE GUARANTEE, TO RECOVER HISTORICAL COSTS.[83]

In the Notice, the Commission seeks comment on the extent to which the ILECs should be guaranteed recovery of any of their historical network or "legacy" costs. As explained above with regard to the TIC, the ILECs should be permitted to the extent allowed by a competitive market, to recover the historical costs of access rate elements to which those costs are reasonably attributable. The Commission should not, however, guarantee such recovery either through bulk billing mechanisms or through separate universal service fund-type reimbursements. No such mechanism is either sound policy or legally required. In fact, to the extent "special recovery" mechanisms are designed to recover such legacy costs from ILEC competitors, competition will be stifled and the consumer benefits envisioned in the Telecommunications Act of 1996 will not be realized.

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[82] If the Commission needs to adopt an interim approach to Phase II, TWComm recommends the adoption of the standards applied to AT&T in the Contract Tariff Order.

[83] This Section relates to Section VII.B of the Notice.

A. There Is No Policy Basis For Guaranteeing ILEC Recovery Of Historical Costs.[84]

The Notice includes several references to the possible need to protect ILECs from the unexpected and dramatic shift in regulations that resulted from the Telecommunications Act of 1996.[85] Implicit in these references is the view that ILECs may have a right to recover costs that they incurred based on an alleged understanding that all costs would be recoverable from ratepayers. This "social contract" argument is seriously flawed as a matter of public policy.

First, even assuming that competitive entry has or will cause significant stranded investment, ILEC shareholders have long been on notice that competition is coming. Any investment in such companies was well-known to be far from risk free. It would therefore be disingenuous for such investors, the large percentage of whom are sophisticated professional money managers, to claim that permitting market forces to take hold represents a breach of some supposed social contract between society and the regulated telephone company.[86]

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84 This Subsection relates to Section VII.B of the Notice.

85 See Notice at ¶ 256.

86 The ILECs have argued in the past that local competition will develop so rapidly that they will not have an adequate chance to lower costs to absorb revenue losses. But history shows that this is very unlikely. For example, AT&T's loss of market share since the 1984 divestiture has been gradual and has in any case been accompanied by an 86.5% increase in AT&T's absolute volume of business. The transition in the local market is likely to be even more gradual and may also be accompanied by an aggregate increase in demand for ILEC services.